

30

Tax Savings for Investors in Securities

Until new legislation restores an exclusion for a portion of net capital gains (net long-term gains over net short-term losses), the only tax advantage of realizing capital gains is the 28% tax rate ceiling for net long-term capital gains; see ¶15.2. Therefore, if your income tax bracket exceeds 28%, you will pay attention to the more than one-year holding period for realizing long-term capital gains on the sale of securities. Realizing long-term capital gains will give you some tax savings. However, do not overlook the fact that realizing substantial capital gains may subject you to the exemption phaseout and/or 3% reduction of itemized deductions. The 3% reduction increases the effective 28% capital gain rate by at least 0.93% and depending on the number of exemptions phased out, the effective rate will be higher. Thus, it may be advisable to avoid realizing too much capital gain income in a year you are subject to the exemption phaseout if that income can be deferred to a year in which you will have lower income and not be subject to the phaseout.

If your tax rate bracket will not exceed 28%, so that short-term and long-term capital gains are subject to the same tax rate, you generally will not pay attention to holding periods. Your test or judging investment return will be the same for both gains and interest and dividend income, which is the net after-tax return over a given period. If the projected after-tax return on a stock that you held for investment will give only 5% over a two-year period, an investment which will return net after-tax income of 7% during the same period will be the preferred investment.

The \$3,000 limitation on deducting capital losses from other types of income is a substantial restriction. If you have capital losses exceeding \$3,000, it is advisable to realize capital gains income that can be offset by the losses.

Security Transactions

Timing Sales of Securities	30.1
Planning Year-End Securities Transactions	30.2
Earmarking Stock Lots	30.3
Sale of Stock Dividends	30.4
Stock Rights	30.5
Short Sales	30.6
Wash Sales	30.7
Convertible Stocks and Bonds	30.8
Straddle Losses	30.9
Capital Gain Restricted for Conversion Transactions	30.10
Puts and Calls and Index Options	30.11
Exchange Option Trading	30.12

Investment Opportunities

Reducing the Tax on Dividend Income	30.13
Treasury Bills and CDs	30.14
Investing in Savings Institutions	30.15
Investing in Corporate Bonds	30.16
Treasury Bonds, Notes, and U.S. Agency Obligations	30.17
Investing in Tax-Exempts	30.18
Investing in Unit Investment Trusts	30.19
Investing in Small Business Stock	30.20
Savings Bond Plans	30.21

See ¶

Security Transactions

Timing sales of securities	See ¶ 30.1
Planning year-end securities transactions	30.2
Earmarking stock lots	30.3
Sale of stock dividends	30.4
Stock rights	30.5
Short sales	30.6
Wash sales	30.7
Convertible stocks and bonds	30.8
Straddle losses	30.9
Capital gain restricted for conversion transactions	30.10
Puts and calls and index options	30.11
Exchange option trading	30.12

substantial gains will place you in the exemption phase-out range (¶22.15). You may want to defer gain transactions to a year in which you will be in a lower bracket or not subject to the phaseout.

December 31 deadline for 1996 gains and losses. If you want to realize gains on publicly traded securities, you have until December 31, 1996, to transact the sale. Gain is reported in 1996, although cash is not received until the settlement date in 1997. If you do not want to realize the gain in 1996, delay the trade date until 1997.

Losses are also realized as of the trade date; a loss on a sale made by December 31, 1996, is reported on your 1996 return.

Planning for losses. Realizing losses may pose a problem if you believe the security is due to increase in value sometime in the near future. Although the wash-sale rule (¶30.7) prevents you from taking the loss if you buy 30 days before or after the sale, the following possibilities are open to you.

- If you believe the security will go up, but not immediately, you can sell now, realize your loss, wait 31 days, and then recover your position by repurchasing before the expected rise.
- You can hedge by repurchasing similar securities immediately after the sale provided they are not substantially identical. They can be in the same industry and of the same quality without being considered substantially identical. Check with your broker to see if you can use a loss and still maintain your position. Some brokerage firms maintain recommended “switch” lists and suggest a practice of “doubling up”—that is, buying the stock of the same company and then 31 days later selling the original shares. Doubling up has disadvantages: It requires additional funds for the purchase of the second lot, exposes you to additional risks should the stock price fall, and the new shares take a new holding period.

¶30.1 Timing Sales of Securities

You have the opportunity to control the taxable year in which to realize gains and losses. Gains and losses are realized only when you sell, and you can time sales to your advantage following the suggestions discussed in this chapter.

Legislative proposals. The timing of your sale transactions could be affected if proposed legislation on long-term capital gains and short sales were to become law. Proposals to reduce taxes on long-term capital gains had not been agreed upon by Congress and the Administration and an Administration proposal to bar tax deferrals through the use of a short sale “against the box” and other deferral transactions had not won Congressional approval when this book went to press. See the Supplement for further developments. An update on any year-end tax legislation will also be provided on J.K. Lasser’s Tax Alert Hotline and the J.K. Lasser Web Page on the World Wide Web; see the inside front cover of this book.

¶30.2 Planning Year-End Securities Transactions

First establish your current gain and loss position for the year. List gains and losses already realized from completed transactions. Then review the records of earlier years to find any carryover capital losses. Include nonbusiness bad debts as short-term capital losses. Then review your paper gains and losses and determine what losses might now be realized to offset actual gains or what gains might be realized to absorb your losses.

If you have already realized net capital losses exceeding \$3,000, you may want to realize capital gains that will be absorbed by the excess loss. Remember, only up to \$3,000 of capital losses exceeding net capital gain may be deducted from other income such as salary, interest, and dividends. Also, project your tax-bracket ranges in the current and next tax year. For example, assume that you are close to the threshold for the phaseout of exemptions and that realizing

EXAMPLE

You own 100 shares of Steel Co. stock which cost you \$10,000. In November 1996, the stock is selling at \$6,000 (\$60 a share × 100 shares). You would like to realize the \$4,000 loss, but, at the same time, you want to hold on to the investment. You buy 100 shares at a market price of \$60 a share (total investment \$6,000) and 31 days later sell your original 100 shares, realizing the loss of \$4,000. You retain your investment in the new lot. In 1996, November 29 is the last day to buy new shares to allow a loss sale on December 31.

Short sale postpones taxable gain to 1997. If you do not want to realize taxable gains on a sale of stock in 1996, but you think that the price of your stock may decline by the time you sell in 1997, you can freeze your profit by ordering a short sale of the stock in 1996. You transact a short sale by selling shares borrowed from your broker. A short sale of securities you already own is called a short sale “against the box.” *Legislation to prevent tax deferrals through short sales “against the box” has been proposed; see the Supplement.*

You close the sale when you deliver to the broker the identical securities you have been holding or identical securities you have bought after the short sale. For example, in January 1997, you deliver your shares to the broker as a replacement for the borrowed shares you sold in 1996. By delivering the stock in 1997, the gain on

the short sale is fixed in 1997. For tax purposes, a short sale is not completed until the covering stock is delivered.

¶30.3 Earmarking Stock Lots

Keep a record of all your stock transactions, especially when you buy the stock of one company at varying prices. By keeping a record of each stock lot, you may control the amount of gain or loss on a sale of a part of your holdings.

If your stock is held by your broker, the IRS considers that an adequate identification is made if you give instructions to your broker about which particular shares are to be sold, and you receive a written confirmation from the broker or transfer agent within a reasonable time.

How To Identify Securities

If your securities are—	Identify them by—
Registered in your own name	The number, your name, and any other identification which they bear.
In a margin account registered in a "street" name	A specified block or security bought on a designated day at a particular price. A mere intention to sell a particular share without informing the broker is without significance.
New certificates received for old in a recapitalization	Record the new certificate with the lowest number as being in exchange for the old certificate with the lowest number. Do this until all the new certificates are matched with all the old.
Shares exchanged for shares in a reorganization	Allocate each of the new certificates to each of the old in your records. Where the exchange involves several blocks of stock and there is no specific identification, the IRS says you must average your costs.
Shares received in a stock split	Match the new certificates with the old ones surrendered. Identification of your selling securities as the "highest cost" or "lowest cost" stock is insufficient. You have to match at the time of the split-up.
Stock dividends	The lot of stock on which you received the dividend. The new stock is part of the old lot. But, if you receive one certificate for more than one lot, you may have to apply the first-in, first-out rule when you sell.
Acquired by exercise of nontaxed stock rights	The number, or other identification, of the lot you receive by exercising the rights. Each lot you so acquire is considered a separate lot received on the date of subscription.

EXAMPLE

Over a three-year period, you bought the following shares of Acme Steel stock: In 1994, 100 shares at \$77 per share; in 1995, 200 shares at \$84 per share; and in 1996, 100 shares at \$105 per share. When the stock is selling at \$90, you plan to sell 100 shares. You may use the cost of your 1996 lot and get a \$1,500 loss if, for example, you want to offset some gains or other income

you have already earned this year. Or you may get capital gains of varying amounts by either selling the 1994 lot or part of the 1995 lot.

You must clearly identify the lot you want to sell. Say you want a loss and sell the 1996 lot. Unless you identify it as the lot sold, the IRS will hold that you sold the 1994 lot under the "first-in, first-out" rule. This rule assumes that, when you have a number of identical items that you bought at different times, your sale of any of them is automatically the sale of the first you bought. So the cost of your first purchase is what you match against your selling price to find your gain or loss. Here is what to do to counteract the first-in, first-out rule: If you have stock certificates registered in your name, show that you delivered the 1996 stock certificates. If the broker is holding the stock, specifically identify the 1996 lot in your selling instructions and get a written confirmation. See the chart in ¶32.10 for averaging cost on the sale of mutual-fund shares.

¶30.4 Sale of Stock Dividends

A sale of stock originally received as a dividend is treated as any other sale of stock. The holding period of a *taxable* stock dividend (¶4.8) begins on the day after the date of distribution. The holding period of a *tax-free* stock dividend or stock received in a split (¶4.6) starts from the time you acquired the original stock.

EXAMPLE

You bought 100 shares of X Co. stock on December 3, 1994. On August 12, 1996, you receive 10 shares of X Co. stock as a tax-free stock dividend. On December 9, 1996, you sell the 10 shares at a profit. You report the sale as long-term capital gain because the holding period of the 10 shares goes back to your original purchase date of December 3, 1994, not August 12, 1996.

Basis of tax-free dividend in the same class of stock. Assume you receive a common stock dividend on common stock. You divide the original cost by the total number of old shares and new shares to find the new basis per share.

EXAMPLE

You bought 100 shares of common stock for \$1,000, so that each share has a basis of \$10. You receive 100 shares of common as a tax-free stock dividend. The basis of your 200 shares remains \$1,000. The new cost basis of each share is now \$5 (\$1,000 ÷ 200 shares). You sell 50 shares for \$560. Your profit is \$310 (\$560 – \$250).

Basis of tax-free dividend in a different class of stock. Assume you receive preferred stock dividends on common stock. You divide the basis of the old shares over the two classes in the ratio of their values at the time the stock dividend was distributed.

EXAMPLE

You bought 100 shares of common stock for \$1,000. You receive a tax-free dividend of 10 shares of preferred stock. On the date of distribution, the market value of the common stock is \$9 a share and that of the preferred stock is \$30. That makes the market value of your common stock \$900 and your preferred stock \$300. So you allocate 75% (\$900 ÷ \$1,200) of your \$1,000 original cost, or \$750, to your common stock and 25% (\$300 ÷ \$1,200) of your cost to the preferred stock.

Basis of taxable stock dividend. The basis of a taxable stock dividend is its fair market value at the time of the distribution. Its holding period begins on the date of distribution. The basis of the old stock remains unchanged.

EXAMPLE

You bought 1,000 shares of stock for \$10,000. The company gives you a choice of a cash dividend or stock (one share for every hundred held). You elect the stock. On the date of the distribution, its market value was \$15 a share. The basis of the new stock is \$150 (10 × \$15). The basis of the old stock remains \$10,000.

The tax treatment of the receipt of stock as a dividend and in a split is discussed at ¶4.6.

Basis of public utility stock received under dividend reinvestment plan. For several years before 1986, an exclusion was allowed for stock dividends received from public utility companies if the dividends were reinvested in stock. If you claimed the exclusion, the stock takes a zero basis. If you sell the stock, the entire sales proceeds of the stock are reported as long-term capital gain.

¶30.5 Stock Rights

The tax consequences of the receipt of stock rights are discussed at ¶4.6. The following is an explanation of how to treat the sale, exercise, or expiration of nontaxable stock rights. The basis of taxable rights is their fair market value at the time of distribution.

Expiration of nontaxable distributed stock rights. When you allow nontaxable rights to expire, you do not have a deductible loss; you have no basis in the rights.

Sale of nontaxable distributed stock rights. If you sell stock rights distributed on your stock, you treat the sale as the sale of a capital asset. The holding period begins from the date you acquired the original stock on which the rights were distributed.

Purchased rights. If you buy stock rights, your holding period starts the day after the date of the purchase. Your basis for the rights is the price paid; this basis is used in computing your capital gain or loss on the sale.

If you allow purchased rights to expire without sale or exercise, you realize a capital loss. The rights are treated as having been sold on the day of expiration. When purchased rights become worthless during the year prior to the year they lapse, you have a capital loss

which is treated as having occurred on the last day of the year in which they became worthless.

Exercise of stock rights. You realize no taxable income on the exercise of stock rights. Capital gain or loss on the new stock is recognized when you later sell the stock. The holding period of the new stock begins on the date you exercised the rights. Your basis for the new stock is the subscription price you paid plus your basis for the rights exercised.

Figuring the basis of nontaxable stock rights. Whether rights received by you as a stockholder have a basis depends on their fair market value when distributed. If the market value of rights is less than 15% of the market value of your old stock, the basis of your rights is zero, unless you elect to allocate the basis between the rights and your original stock. You make the election on your tax return for the year the rights are received by attaching to your return a statement that you are electing to divide basis. Keep a copy of the election and the return.

If the market value of the rights is 15% or more of the market value of your old stock, you must divide the basis of the stock between the old stock and the rights, according to their respective values on the date of distribution.

No basis adjustment is required for stock rights that become worthless during the year of issue.

EXAMPLE

You own 100 shares of M Co. that cost \$10 a share. On September 15, there is a distribution of stock rights allowing for the purchase of one additional share of common for each 10 rights held at a price of \$13 a share. The common stock is now worth \$15 (ex-rights). The rights have a market value of 20¢ each. This is less than 15% of the market value of the stock. You can either: (1) choose not to spread the tax cost of the stock between the old stock and the rights, or (2) elect to spread the tax cost as follows:

Cost of your old stock, 100 shares at \$10, or \$1,000.

Fair market value of old stock, 100 shares at \$15, or \$1,500.

Market value of 100 rights at 20¢, or \$20.

Market value of both old stock and rights, \$1,520.

Apportionment of old stock:

$$\frac{\$1,500}{\$1,520} \times 1,000 = 986.84$$

Your new basis of old stock is \$986.84 for 100 shares, or \$9.87 a share. The tax cost of the rights is then calculated:

$$\frac{\$20}{\$1,520} \times 1,000 = \$13.16$$

Basis of the rights is \$13.16 for 100 rights.

When you exercise your rights and 10 shares are bought, your basis for the new stock is \$130 plus the cost of the rights of \$13.16, or \$143.16.

If the option of allocation is not exercised, the rights have a basis of zero and the basis of the new stock is \$130. The basis of the old stock remains \$1,000.

¶30.6 Short Sales

You sell short when you sell borrowed securities. You usually borrow the securities from your broker. When you sell short, you may: (1) own the identical securities but do not want to sell them just now; or (2) *not* own the securities. A short sale of securities you already own is called a short sale “against the box.” You *close* the short sale when you deliver to the broker the identical securities you have been holding or identical securities you have bought after the short sale. You report gain or loss from a short sale in the year you close the short sale.

The Administration has proposed a repeal of the tax-deferral feature of short sales against the box. However, when this book went to press, Congress had not acted on the proposal; see the Supplement for developments, if any.



Investment Goal of Short Sales

Some objectives of selling short: You may want to profit from a declining market in the hope you can buy the replacement stock at lower prices, freeze paper profits in an uncertain market, or postpone gain to another year.

EXAMPLES

1. In December 1996, you want to freeze your profit in Z stock, but you want to report the sale in 1997. You sell Z short on December 13, 1996. On January 2, 1997, you close the short sale by delivering your Z stock. The short sale is reported as gain on your 1997 return. You report a short sale in the year in which you close the short sale.
2. You sell short 100 shares of Steel Co. for \$5,000. You borrowed the stock from your broker. The market declines. Thirteen months later, you buy 100 shares of Steel Co. stock for \$3,000, which you deliver to your broker to close the short sale. Your profit of \$2,000 is taxed as short-term capital gain. Your profit would be short term regardless of how long you kept the sale open; see Rule 1 in the next column.

Tax consequences of short sales. When analyzing short-sale transactions, ask yourself these two questions:

1. When you sold short, did you or your spouse hold short-term securities substantially identical to the securities sold short? (Substantially identical securities are described at ¶30.7.)
2. After the short sale, did you or your spouse acquire substantially identical securities on or before the date of the closing of the short sale?

If you answered “yes” to either or both of these questions, apply the following two rules:

Rule 1. Gain realized on the closing of the short sale is short term. The gain is short term regardless of the period of time you have held the securities as of the closing date of the short sale.

Rule 2. The beginning date of the holding period of substantially identical stock is suspended. The holding period of substantially identical securities owned or bought under the facts of question (1) or (2) in the preceding column does not begin until the date of the closing of the short sale (or the date of the sale, gift, or other disposition of the securities, whichever date occurs first). But note that this rule applies only to the number of securities that do not exceed the quantity sold short.

A put as a short sale. The acquisition of a *put* (an option to sell) is treated as a short sale if you hold substantially identical securities short term at the time you buy the put. The exercise or failure to exercise the put is treated as the closing of the short sale. However, the short-sale rules do not apply if on the same day you buy a put and stock which is identified as covered by the put. If you do not exercise the put which is identified with the stock, add its cost to the basis of the stock.

EXAMPLES

1. Short-term gain on closing short sale (Rule 1)

Oct. 1, 1995: You buy 100 shares of Steel Co. at \$10 a share.

March 1, 1996: You sell “short against the box” 100 shares of Steel Co. at \$16 a share.

Oct. 7, 1996: You close the short sale by delivering the stock bought on Oct. 1, 1995.

Result:

You have a short-term capital gain of \$600 in 1996. On the date of the short sale (March 1), you held 100 shares of Steel Co. stock short term, as they were not held for more than one year. That more than a year elapsed between the purchase and closing date is immaterial.

2. Holding period suspended (Rule 2)

Oct. 1, 1995: You buy 100 shares of Steel Co. at \$10 a share.

March 1, 1996: You sell “short against the box” 100 shares of Steel Co. at \$16 a share.

Oct. 7, 1996: You close the short sale with 100 shares you buy today at \$18.

Oct. 14, 1996: You sell at \$18 a share the lot bought on Oct. 1, 1995.

Result:

(a) You have a short-term loss of \$200 on the closing of the short sale:

Sales Price	\$1,600
Cost	<u>1,800</u>
Loss	(\$ 200)

(b) You have a short-term gain of \$800 on the sale of the lot bought on October 1, 1995 (\$1,800 – \$1,000). Gain is short term although you held the lot for more than one year. The Oct. 1 lot was substantially identical stock held short term at the time of the short sale on Mar. 1. Under the special holding-period rule, the holding period of the Oct. 1 lot did not begin until the closing of the short sale on Oct. 7, 1996.

The effect of the holding-period rule is to give the same tax result that would have been realized if you had sold the Oct. 1, 1995, lot on Mar. 1, 1996, instead of making a short sale on that date. On Mar. 1, a sale would have given you a short-term gain of \$600.



Losses on Short Sales

A loss on a short sale is not deductible until shares closing the short sale are delivered to the broker. You may not realize a short-term loss on the closing of a short sale if you held substantially identical securities long term on the date of the short sale. The loss is long term. This rule prevents you from creating short-term losses when you held the covering stock long term. Loss deductions on short sales may be disallowed under the wash-sale rules of ¶30.7.

Expenses of short sales. Before you buy stock to close out a short sale, you pay the broker for dividends paid on stock you have sold short. If you itemize deductions, you may treat your payment as investment interest (¶15.10), provided the short sale is held open at least 46 days, or more than a year in the case of extraordinary dividends. If the 46-day (or one-year) test is not met, the payment is generally not deductible and is added to basis; in counting the short-sale period, do not count any period during which you have an option to buy or are obligated to buy substantially identical securities, or are protected from the risk of loss from the short sale by a substantially similar position.

Under an exception to the 46-day test, if you receive compensation from the lender of the stock for the use of collateral and you report the compensation as ordinary income, your payment for dividends is deductible to the extent of the compensation; only the excess of your payment over the compensation is disallowed. This exception does not apply to payments with respect to extraordinary dividends.

An extraordinary dividend is generally a dividend that exceeds in value 10% of the amount realized on the short sale, or 5% in the case of a preferred stock. For purposes of this test, dividends on stock received within an 85-day period are aggregated; a one-year aggregation period applies if dividends exceed 20% of the adjusted basis in the stock.

Arbitrage transactions. Special holding-period rules apply to short sales involved in identified arbitrage transactions in convertible securities and stock into which the securities are convertible. These rules can be found in Treasury regulations to Internal Revenue Code Section 1233.

period of time after the sale. Under the wash-sale rule, your loss deduction is barred if within 30 days of the sale you buy *substantially identical* stock or securities, or a “put” or “call” option on such securities. The wash-sale period is 61 days—running from 30 days before to 30 days after the date of sale. The end of a taxable year during this 61-day period does not affect the wash-sale rule. The loss is still denied. If you sell at a loss and your spouse buys substantially identical stock within this period, the loss is also barred.

The wash-sale rule does not apply to gains. It also does not apply to acquisitions by gift, inheritance, or tax-free exchange.

The wash-sale rule applies to investors and traders. It does not apply to dealers.

Loss on sale of part of a stock lot bought less than 30 days ago.

If you buy stock and then, within 30 days, sell some of those shares, a loss on the sale is deductible; the wash-sale disallowance rule does not apply.

EXAMPLE

You buy 200 shares of stock. Within 30 days, you sell 100 shares at a loss. The loss is not disallowed by the wash-sale rule. The wash-sale rule does not apply to a loss sustained in a bona fide sale made to reduce your market position. It does apply when you sustain a loss for tax purposes with the intent of recovering your position in the security within a few days. Thus if, after selling the 100 shares, you repurchase 100 shares of the same stock within 30 days after the sale, the loss is disallowed.

Oral sale-repurchase agreement. The wash-sale rule applies to an oral sale-repurchase agreement between business associates.

Defining “substantially identical.” What is substantially identical stock or securities? Buying and selling General Motors stock is dealing in an identical security. Selling General Motors and buying Chrysler stock is not dealing in substantially identical securities.

Bonds of the same obligor are substantially identical if they carry the same rate of interest; that they have different issue dates and interest payment dates will not remove them from the wash-sale provisions. Different maturity dates will have no effect, unless the difference is economically significant. Where there is a long time span between the purchase date and the maturity date, a difference of several years between maturity dates may be considered insignificant. A difference of three years between maturity dates was held to be insignificant where the maturity dates of the bonds, measured from the time of purchase, were 45 and 48 years away. There was no significant difference where the maturity dates differed by less than one year, and the remaining life, measured from the time of purchase, was more than 15 years.

The wash-sale rules do not apply if you buy bonds of the same company with substantially different interest rates; buy bonds of a different company; or buy substantially identical bonds outside of the wash-sale period.

Warrants. A warrant falls within the wash-sale rule if it is an option to buy substantially identical stock. Consequently, a loss on the sale of common stocks of a corporation is disallowed when warrants for the common stock of the same corporation are bought within the period 30 days before or after the sale. But if the timing is

¶30.7 Wash Sales

The objective of the wash-sale rule is to disallow a loss deduction where you recover your market position in a security within a short

reversed—that is, you sell warrants at a loss and simultaneously buy common stock of the same corporation—the wash-sale rules may or may not apply depending on whether the warrants are substantially identical to the purchase stock. This is determined by comparing the relative values of the stock and warrants. The wash-sale rule will apply only if the relative values and price changes are so similar that the warrants become fully convertible securities.



Basis Adjusted for New Stock

Although the loss deduction is barred if the wash-sale rule applies, the economic loss is not forfeited for tax purposes. The loss might be realized at a later date when the repurchased stock is sold, because after the disallowance of the loss, the cost basis of the new lot is fixed as the basis of the old lot and adjusted (up or down) for the difference between the selling price of the old stock and purchase price of the new stock; see the following Examples.

EXAMPLES

1. You bought common stock of Appliance Co. for \$10,000 in 1981. On June 27, 1996, you sold the stock for \$8,000, incurring a \$2,000 loss. A week later, you repurchased the same number of shares of Appliance stock for \$9,000. Your loss of \$2,000 on the sale is disallowed because of the wash-sale rule. The basis of the new lot becomes \$11,000. The basis of the old shares (\$10,000) is increased by \$1,000, which is the excess of the purchase price of the new shares (\$9,000) over the selling price of the old shares (\$8,000).
2. Assume the same facts as in Example 1 except that you repurchase the stock for \$7,000. The basis of the new lot is \$9,000. The basis of the old shares (\$10,000) is decreased by \$1,000, which is the excess of the selling price of the old shares (\$8,000) over the purchase price of the new shares (\$7,000).
3. Assume that in February 1997 you sell the new lot of stock acquired in Example 1 above for \$9,000 and do not run afoul of the wash-sale rule. On the sale, you realize a loss of \$2,000 (\$11,000 – \$9,000).

Repurchasing fewer shares. If the number of shares of stock reacquired in a wash sale is less than the amount sold, only a proportionate part of the loss is disallowed.

EXAMPLE

You bought 100 shares of Stock A for \$10,000. On December 13, 1996, you sell the lot for \$8,000, incurring a loss of \$2,000. On January 2, 1997, you repurchase 75 shares of Stock A for \$6,000. Three-quarters (75/100) of your loss is disallowed, or \$1,500 ($\frac{3}{4}$ of \$2,000). You deduct the remaining loss of \$500 on your return for 1996. The basis of the new shares is \$7,500 (\$6,000 cost plus \$1,500 disallowed loss).

Holding period of new stock. After a wash sale, the holding period of the new stock includes the holding period of the old lots. If you sold more than one old lot in wash sales, you add the holding periods of all the old lots to the holding period of the new lot. You do this even if your holding periods overlapped as you purchased another lot before you sold the first. You do not count the periods between the sale and purchase when you have no stock.

Losses on short sales. Losses incurred on short sales are subject to the wash-sale rules. A loss on the closing of a short sale is denied if you sell the stock or enter into a second short sale within the period beginning 30 days before and ending 30 days after the closing of the short sale.



Tax Advantage of Wash-Sale Rule

Sometimes the wash-sale rule can work to your advantage. Assume that during December you are negotiating a sale of real estate that will bring you a large capital gain. You want to offset a part of that gain by selling certain securities at a loss. You are unsure just when the gain transaction will go through. It may be on the last day of the year. Then it may be too late to sell the loss securities before the end of the same year.

You can do this: Sell the loss securities during the last week of December. If the profitable deal goes through before the end of the year, you need not do anything further. If it does not, buy back the loss securities early in January. The December sale will be a wash sale and the loss disallowed. When the profitable real estate sale occurs next year, you can sell the loss securities again. This time the loss will be allowed and will offset the gain.

¶30.8

Convertible Stocks and Bonds

You realize no gain or loss when you convert a bond into stock, or preferred stock into common stock of the same corporation, provided the conversion privilege was allowed by the bond or preferred stock certificate.

Holding period. Stock acquired through the conversion of bonds or preferred stock takes the same holding period as the securities exchanged. However, where the new stock is acquired partly for cash and partly by tax-free exchange, each new share of stock has a split holding period. The portion of each new share allocable to the ownership of the converted bonds (or preferred stock) includes the holding period of the bonds (or preferred stock). The portion of the new stock allocable to the cash purchase takes a holding period beginning with the day after acquisition of the stock.

Basis. Securities acquired through the conversion of bonds or preferred stock into common take the same basis as the securities exchanged. Where there is a partial cash payment, the basis of the portion of the stock attributable to the cash is the amount of cash paid; see Examples 1 and 2 on the next page.

If you paid a premium for a convertible bond, you may not amortize the amount of the premium that is attributable to the conversion feature.

EXAMPLES

1. On January 2, 1996, you paid \$100 for a debenture of A Co. Your holding period for the debenture begins on January 3; see ¶15.13. The debenture provides that the holder may receive one share of A Co. common stock upon surrender of one debenture and the payment of \$50. On October 18, you convert the debenture to stock on payment of \$50. For tax purposes, you realize no gain or loss upon the conversion regardless of whether the fair market value of the stock is more or less than \$150 on the date of the conversion. The basis and holding period for the stock is as follows: \$100 basis for the portion attributed to the ownership of the debenture with the holding period beginning January 3; and \$50 basis attributed to the cash payment with the holding period for this portion beginning October 20.
2. Same facts as in the above Example, but you acquired the debenture on January 2 through the exercise of rights on that date. Since the holding period for the debenture includes the date of exercise of the rights, see ¶130.5, the portion of the stock allocable to the debenture takes a holding period beginning on January 3.

¶30.9 Straddle Losses

Straddles are tax-shelter devices to spot losses in one year and gains in another year and to convert ordinary income into capital gain. These maneuvers are now effectively barred by tax accounting rules that generally match losses against unrealized gains in offsetting positions. Straddle rules apply to commodities and actively traded stock and to stock options used in straddle positions. Straddle positions include any stock that is part of a straddle in which at least one of the offsetting positions is: (1) an option tied to the stock or to substantially identical stock or securities; or (2) a position in substantially similar or related property other than stock. For example, there is a straddle of stock and substantially similar or related property if offsetting positions of stock and convertible debentures of the same corporation are held and price movements of the two positions are related.

Straddle rules apply also to stock of a corporation formed or used to take positions in personal property that offset positions taken by any shareholder. True *hedging* transactions are not subject to the straddle tax rules.

Also, a call option is not treated as part of a straddle position if it is considered a *qualified covered call option*. A qualified covered call option is an option that a stockholder who is not a dealer grants on stock traded on a national securities exchange. Furthermore, the option must be granted more than 30 days before its expiration date and must not be “deep-in-the-money.” A covered call option will not qualify if gain on the sale of the stock to be purchased by the option is reported in a year after the year in which the option is closed, and the stock is not held for 30 days or more after the date on which the option is closed. In such a case, the option is subject to the straddle loss deferral rules. The same loss deferment rule applies where the

stock is sold at a loss, and gain on the related option held less than 30 days is reported in the next year.

Loss on a qualified covered call option with a strike price less than its applicable stock price is treated as long-term capital loss if loss realized on the sale of the stock would be long term. The holding period for stock subject to the option does not include any period during which the taxpayer is the grantor of the option.

A “deep-in-the-money” option is an option with a strike or exercise price that is below the lowest qualified benchmark. The technical rules for determining these values are not discussed in this book.

Tax rules for straddles. The following is an overview of the subject, and if you have transacted straddles, we suggest that you consult with an experienced tax practitioner.

Realized straddle losses are deductible at the close of a taxable year only if they exceed unrealized gains in an offsetting position. Thus, an investor may not deduct losses incurred in 1996 to the extent that he or she has an unrealized gain position in the open end of the straddle. Form 6781 is used for reporting gains and losses on straddle positions and on Section 1256 contracts under the marked-to-market rules discussed later in this section.

Straddle positions of related persons (such as a spouse or child) or controlled flow-through entities (such as a partnership or an S corporation) are considered in determining whether offsetting positions are held.

Realized losses that are not deductible at the end of the year are carried forward and become deductible when there is no unrealized appreciation in an offsetting position bought before the disposition of the loss position. This loss deferral rule may be avoided by identifying straddles before the close of the day of acquisition or at an earlier time that the IRS may set. Gain or loss in identified positions is generally netted; that is, a loss is recognized when the offsetting gain position has been closed.

If you are in a straddle arrangement, you must disclose all positions of unrealized gains at the close of a tax year or you may be subject to a negligence penalty unless failure to disclose is due to a reasonable cause.

The loss deferral rule does *not* apply to positions in a regulated futures contract or other Section 1256 contract subject to the marked-to-market system explained later in this section.

The loss deferral rule also does not apply to businesses that must hedge in order to protect their supplies of inventory or financial capital. Hedging transactions are subject to ordinary income or loss treatment. Hedging transactions entered into by syndicates do not qualify for the exception and are subject to the loss deferral rule if more than 35% of losses for a taxable year are allocable to limited partners or entrepreneurs. Furthermore, hedging losses of limited partners or limited entrepreneurs are generally limited to their taxable income from the business in which the hedging transaction was entered into.

Conversion transactions. On certain so-called “conversion transactions,” discussed at ¶30.10, gain realized on the disposition of certain positions is treated as ordinary income instead of capital gain.

Marked-to-market rules for gain or loss on regulated futures contracts and other Section 1256 contracts. Gain or loss on regu-

lated futures contracts is reported annually under the marked-to-market accounting system of regulated commodity exchanges. To settle margin requirements, regulated exchanges determine a party's account for futures contracts on a daily basis. Each regulated futures contract is treated as if sold at fair market value on the last day of the taxable year. Any capital gain or loss is arbitrarily allocated: 40% is short term and 60% is long term. Use Form 6781 to figure gains and losses on Section 1256 contracts that are open at the end of the year or that were closed out during the year. These amounts are then transferred from Form 6781 to Schedule D.

Under the law, a regulated futures contract is considered a Section 1256 contract. Other Section 1256 contracts subject to the marked-to-market rules are foreign currency contracts, dealer equity options, and non-equity options.

The marked-to-market rules do not apply to true hedging transactions executed in the normal course of business to reduce risks and which result in ordinary income or loss. Syndicates may generally not take advantage of this hedging exception if more than 35% of their losses during a taxable year are allocable to limited partners or entrepreneurs. Further, the ability of entrepreneurs or limited partners to deduct losses from hedging transactions is generally limited to taxable income from the business to which the hedging transaction relates.

Mixed straddle contracts. If you have a mixed straddle in which at least one but not all of the positions is a Section 1256 contract, the marked-to-market rules generally apply but you may elect to avoid this treatment and apply the regular straddle tax rules. The election, made on Form 6781, is irrevocable unless the IRS allows a revocation. Furthermore, the IRS allows an election to offset gains and losses from positions that are part of mixed straddles if you separately identify each mixed straddle or establish mixed straddle accounts for a class of activities for which gain and loss will be recognized and offset on a periodic basis.



Carryback Election

If for 1996 you have a net loss on Section 1256 contracts, the loss may be carried back for three years under special rules. To claim the net loss, you must file an amended return (Form 1040X) and an amended Form 6781 for the prior year. Follow the instructions to Form 6781.

Contract cancellations. Investors buying forward contracts for currency or securities may not realize ordinary loss by cancelling the unprofitable contract of the hedge transaction. Loss realized on a cancellation of the contract is treated as a capital loss.

Cash-and-carry transactions. You may not deduct carrying costs for any period during which the commodity or stock or option is part of a balanced position. The costs must be capitalized and added to basis. The rule does not apply to hedging straddles. Capitalized items are reduced by dividends on stock included in a straddle, market discounts, and acquisition discounts. These reductions, however, are limited to so much of the dividends and discounts as is included in income.

¶30.10 Capital Gain Restricted for Conversion Transactions

A “conversion transaction” is a transaction generally involving two or more positions taken with regard to the same or similar property. The investor is in the economic position of a lender who expects to receive income while undertaking no significant risks other than those of a lender. Where substantially all of your expected return is in the nature of interest on a loan from the following types of transactions, some or all of the income earned on the transaction is treated as ordinary income rather than capital gain:

1. You acquire property and also agree to sell the property or substantially identical property for a determined price;
2. You take offsetting positions on a straddle transaction; *or*
3. You invest in a transaction marketed or sold as producing capital gain but your expected return is in the nature of interest on a loan.

Option dealers and commodity dealers are generally exempt from the new limitations.

Amount treated as ordinary income. In a conversion transaction, the amount of ordinary income is limited to an “applicable imputed income amount.” This is generally the amount of interest that would have accrued on the net investment in the conversion transaction for the period ending on the date of disposition. To figure the interest element, 120% of the applicable federal rate, compounded semiannually, is used. The applicable rate is the federal short-term, mid-term, or long-term rate, depending on the term of the transaction. If the term is indefinite, the federal short-term rate is used. The federal rates are determined monthly and published in the Internal Revenue Bulletin.

EXAMPLE

On January 2, 1996, Jones buys stock for \$100 and on the same day agrees to sell it to Brown for \$115 on January 5, 1998. Assume the applicable federal rate is 5%. On January 5, 1998, Jones delivers the stock to Brown for \$115. If the conversion transaction rule did not apply, Jones would recognize a capital gain of \$15 (\$115 sale price less \$100 purchase price). However, under the conversion transaction rules, \$12.36 of the gain is ordinary income (\$12.36 is \$100 times 6% compounded for two years; 6% is 120% of the 5% federal rate). The balance of the gain, or \$2.64, is long-term capital gain (\$15 less \$12.36).

Where a loan finances a conversion transaction and interest is capitalized (under a provision applied to straddles), the amount of ordinary income reported is reduced.

If the conversion transaction involves a “built-in” loss, the loss is recognized without regard to the conversion rules. For example, if the loss is a capital loss, it remains a capital loss although the conversion rules apply to the transaction.

Form 6781. You report conversion transactions on Form 6781. The ordinary income element is not reported as interest income, but as an ordinary gain on Form 4797.

¶30.11 Puts and Calls and Index Options

You may buy options to buy and sell stock. On the stock exchange, these options are named calls and puts. A call gives you the right to require the seller of the option to sell you stock during the option period at a fixed price, called the exercise or strike price. A put gives you the right to require the seller of the option to buy stock you own at a fixed price during the option period. *See* the chart below for an explanation of different option terms.

The option price depends on the value of the stock, the length of the option period, the volatility of the stock, and the demand and supply for options for the particular stock.

Puts may be treated as short sales. Be careful in using puts when you own stock covered by the put. If you have held the stock short term, the purchase of the put is a short sale. The exercise or expiration of the put will then be treated as the closing of the short sale. Short-sale rules, however, do not apply (1) when you hold stock long term, and (2) when you buy a put and the related stock on the same day and identify the stock with the put; *see* ¶30.6.



Speculate With Puts and Calls

Puts and calls allow you to speculate at the expense of a small investment—a call, for expected price rises, and a put, for expected price declines. They may also be used to protect paper profits or fix the amount of your losses on securities you own.

You do not have to exercise a put or call to realize your profit. You may sell the option to realize your profit. If you exercise a call, the cost of the call is added to the cost of the stock purchased. If you exercise a put, you reduce the selling price of stock sold by the cost of the put. If you do not exercise a call or put, you realize a capital loss.

Buyers of options. If you buy an option, the tax treatment of your investment in the option depends on what you do with it.

1. If you sell it, you realize short-term or long-term capital gain or loss, depending upon how long you held the option.
2. If you allow the option to expire without exercise, you incur a short-term or long-term capital loss, depending on the holding period of the option. The expiration date is treated as the date the option is disposed of.
3. If you exercise the option and buy the stock, you add the cost of the option to the basis of the stock.



Key to Option Terms

Item	Explanation
Call option	An option contract that gives the holder the right to buy a specified number of shares of the underlying stock at the given exercise price on or before the option expiration date.
Put option	An option contract that gives the holder the right to sell a specified number of shares of the underlying stock at the given exercise price on or before the option expiration date.
Strike price/Exercise price	The stated price per share for which the underlying stock may be bought (in the case of a call) or sold (in the case of a put) by the option holder upon exercise of the option contract.
At-the-money	An option is at-the-money if the exercise price of the option is equal to the market price of the underlying security.
In-the-money	A call option is in-the-money if the exercise price is less than the market price of the underlying security. A put option is in-the-money if the exercise price is greater than the market price of the underlying security.
Out-of-the-money	A call option is out-of-the-money if the exercise price is greater than the market price of the underlying security. A put option is out-of-the-money if the strike price is less than the market price of the underlying security.
Premium	The price of the option contract determined in the competitive marketplace, which the buyer of the option pays to the option writer.
Intrinsic value	The amount by which the option is in-the-money.
Time value (premium-intrinsic value)	The portion of the premium that is attributable to the amount of time remaining until the option's expiration date and to the fact that the underlying components that determine the value of the option may change during that time.
Secondary market	A market that provides for the purchase or sale of previously sold or bought options through closing transactions.
Expiration date	The expiration date is the last day on which an option may be exercised.
Writer	The seller of an option contract.

Grantors of options. If you write an option through the exchange, you do not treat the premium received for writing the option as income at the time of receipt. You do not realize profit or loss until the option transaction is closed. This may occur when the option expires or is exercised or when you “buy in” on the exchange an option similar to the one you gave to end your obligation to deliver the stock. Here are the rules for these events:

1. If the option is not exercised, you report the premium as short-term capital gain in the year the option expires.
2. If the option is exercised, you add the premium to the sales proceeds of the stock to determine gain or loss on the sale of the stock. Gain or loss is short term or long term depending upon the holding period of the stock.
3. If you “buy in” an equivalent option in a closing transaction, you realize profit or loss for the difference between the premium of the option you sold and the cost of the closing option. The profit or loss is treated as short-term capital gain or loss. However, a loss on a covered call that has a stated price below the stock price may be long-term capital loss if, at the time of the loss, long-term gain would be realized on the sale of the stock. Furthermore, the holding period of such stock is suspended during the period in which the option is open. Finally, year-end losses from covered call options are not deductible, unless the stock is held uncovered for more than 30 days following the date on which the option is closed.

Using a call as leverage. You expect a stock to appreciate in value but you do not have sufficient capital for a further investment. Instead of investing your limited amount of capital in an outright purchase, you might buy a call covering such stock. With a call, the same amount of capital allows you to speculate in many more shares than you could if you purchased stock outright. If the stock rises in value, your call also increases in value.

(1) the owner of shares who sells an option on his or her stock; and (2) the option buyer who generally speculates that, by buying an option for a smaller price than he or she would have to pay for the stock, a profit can be made if the price of the stock goes up. The odds generally favor the option seller.

If you are inexperienced in the use of options, read several technical explanations of the use of options before investing. Master the technical use of options such as straddles and hedges used by professional traders, as the outright purchase of straight calls is generally too speculative. Finally, do not overlook commission costs which can cut into your profits or increase your losses.

Stock index options. Index options give you a chance to speculate on the general movement of stock prices. The success of the index option has tended to reduce interest in regular stock options given on individual stocks. On the other hand, index options are pegged to the price movement of the stocks that comprise the index option. Thus, with index options, you do not have to be concerned about the market fate of a particular stock. The stock group of the index option follows the general stock market movement. For example, assume that 100 stocks make up the index. The option contract represents an index multiplier of \$100 times the index value of the group or basket of 100 stocks. Therefore, when a newspaper reports an index value of 170, which is also called the “strike price,” the contract is worth \$17,000. However, as the option is only a right to buy or sell this particular contract, you pay an option price that is only a percentage of the contract value. The particular option price is set by the market in an open auction.

Your role is to weigh how the market will fare within the option period. Should you anticipate lower interest rates within the option period, which can be from approximately a week up to three months, you might buy an index option, betting that the stock market will advance. For example, when the index is at 165, you buy an option for \$1,200 with a strike price of 170. If the stock market advances during the option period, pushing the strike price to 177, you have won your bet. At 177, you might sell your option for \$7,000, thereby making a \$5,800 profit.

Do not let this example encourage you to enter the index option market precipitously. If you guess wrong, you have lost your money. In the example just cited, had the index not moved above 170, you would have lost \$1,200. However, unlike other investments where the risk may be unlimited, options offer buyers a known risk in that the buyer cannot lose more than the premium paid for the option or, in other words, the price paid for the option.

The Chicago Board Options Exchange offers the S&P 100 index option, the largest in the country, based on Standard and Poor’s 100 list of stocks. A broad-based index option of 500 stocks is also offered. The Philadelphia Stock Exchange trades the Value Line index option, a broad-based index of approximately 1,700 stocks. The New York Stock Exchange and the American Stock Exchange also offer index options.

If you are interested in playing the index option market, track the market for several months until you get used to the movement of the option. Plot hypothetical purchases and see how you would have fared. You might make a bundle—but, as at roulette, you might lose your shirt in a very short time.

¶30.12 Exchange Option Trading

Option market exchanges provide market conditions for trading in puts and call options. The overwhelming number of options transacted are calls. Financial sections of the daily newspapers provide data on the market prices and volume of the options.

Options are currently traded on the following U.S. exchanges: the American Stock Exchange (AMEX), the Chicago Board Options Exchange (CBOE), the New York Stock Exchange (NYSE), the Pacific Stock Exchange (PSE), and the Philadelphia Stock Exchange (PHLX). Like trading in stocks, option trading is regulated by the Securities and Exchange Commission (SEC). Furthermore, all option contracts traded on U.S. exchanges are issued and cleared by the Options Clearing Corporation (OCC).

Trading in options is highly speculative, attracting those who hope to make profits on minimum investments. At the same time, the market has provided investors and institutions holding large portfolios with an opportunity to earn income through the sale of options based on their holdings. Thus, it takes two to play the option game:

Non-equity options and dealer equity options, which include options based on regulated stock indexes and interest rate futures, are taxed like regulated futures contracts. This means that they are reported annually under the marked-to-market accounting system. You treat all such options held at the end of the year as if they were disposed of at year-end for a price equal to fair market value. Any gain or loss is arbitrarily taxed as if it were 60% long term and 40% short term. It is advisable to ask your broker whether the specific options which you hold come within this special rule.

Investment Opportunities

	See ¶
Reducing the tax on dividend income	30.13
Treasury bills and CDs	30.14
Investing in savings institutions	30.15
Investing in corporate bonds	30.16
Treasury bonds, notes, and U.S. agency obligations	30.17
Investing in tax-exempts	30.18
Investing in unit investment trusts	30.19
Investing in small business stock	30.20
Savings bond plans	30.21

¶30.13 Reducing the Tax on Dividend Income

The tax on dividend income may be reduced by the following types of transactions:

- *Selling stock on which a dividend has been declared but not yet paid.* During the period a dividend is declared but not paid, the price of the stock includes the value of the dividend. If you plan to sell stock in this position and figure that the tax on the dividend reflected in the selling price will be less than the tax on the dividend received, transact the sale before the stock goes ex-dividend; see ¶4.9.
- *Investing in companies paying tax-free dividends.* Some companies pay tax-free dividends. A list of companies that do may be provided by your broker. When you receive a tax-free dividend, you do not report the dividend as income as long as the dividend does not exceed your stock basis. A tax-free dividend reduces the tax cost of your stock. Dividends in excess of basis produce capital gain; see ¶4.11.
- *Investing in companies paying stock dividends.* On receipt of a stock dividend, you generally do not have taxable income.

¶30.14 Treasury Bills and CDs

Short-term paper (maturity of one year or less) provides an opportunity for earning income on funds during periods of uncertainty in the stock and other investment markets. Funds which you do not wish to

tie up long term and do not want to remain unproductive may be invested in Treasury bills, notes, or certificates of deposit. These investments offer safety and negotiability, earning current interest rates from the day of purchase to the day of redemption, either on maturity or sale.

Treasury bills. These are direct obligations of the U.S. Treasury issued to finance budgetary needs. Bills are offered for three-month, six-month, and 12-month maturities in minimum amounts of \$10,000 and multiples of \$1,000 above the minimum. Bills are sold at a discount at Treasury auctions held at the Federal Reserve Banks, which serve as agents for the Treasury. They are redeemed at face value. Your return on a Treasury bill is the difference between the discount price you pay for the bill and its face value, if you hold it to maturity, or the amount you receive for it on a sale before maturity. The selling price of a Treasury bill before maturity will vary with changes of current interest rates.

You may buy Treasury bills directly without charge from any Federal Reserve Bank, which gives you a receipt indicating that a book entry of your purchase has been recorded. You also may buy or sell Treasury bills through your bank or stockbroker, who will charge you for handling the transaction.

Most investors submit *noncompetitive tenders* (bids) for the Treasury bills they wish to buy. To submit a *competitive tender*, you must specify the price you are willing to pay for your bill, and you run the risk of bidding too low and not getting the bills you want. Noncompetitive tenders do not have to specify a price. They are filled at a price which is the average of the accepted competitive tenders for that specific auction. Check the Federal Reserve Bank or branch in your area for auction dates on Treasury bills. You may also buy or sell Treasury bills through your bank or your stockbroker, who will charge you for handling the transaction.

Figuring the yield on your Treasury bill. On the day of the auction, the Treasury will figure the average price bid by those who submitted acceptable competitive tenders. The difference between this average price and the full value of the Treasury bill is the *discount* at which the bill is sold. All noncompetitive tenders are filled at this price. The Treasury pays you the difference between the purchase price and the face value.

EXAMPLE

Assume the accepted average bid on three-month bills is \$9,850. You gave the government \$10,000. To reflect the actual purchase price of \$9,850, a "discount" of \$150 is paid to you.

Figuring Treasury bill yield. The equivalent annual yield on your Treasury bill is figured this way:

1. Find the yield on your investment by dividing discount by purchase price.
2. Convert this yield to the annual rate by multiplying the yield by 4.0110 (365 ÷ 91 days to maturity) if the bill is for three months and by 2.0055 (365 ÷ 182 days to maturity) if the bill is for six months.

On a three-month bill your discount is \$100 (cost \$9,900); the equivalent annual yield is 0.04051:

$$\frac{\$100}{\$9,900} = 0.0101 \quad 0.0101 \times 4.0110 = 0.04051, \text{ or } 4.051\% \text{ per year}$$

Financial pages of the newspapers report the previous day's auction, including the discount rate and what this amounts to as an annual percentage yield.

Cashing bills before maturity. If you decide you need funds before the maturity date of your bill, you can sell it through a commercial bank or a securities broker. The Federal Reserve Bank and the Treasury do not handle bills which have not matured.

For bills sold before maturity, current interest rates will determine the amount you receive. The market value of Treasury bills is listed daily in the financial section of newspapers.

At maturity. Redemption is automatic at maturity, unless you notify the Federal Reserve Bank that you wish to roll over matured bills into new bills. The Treasury will electronically deposit the face amount of the bill into a savings or checking account you have previously designated. If you bought your bill through a bank, the bank will credit your account on the date the bill matures. To roll over your maturing bill, you follow the same procedures as in buying a new bill and use your matured bill as payment. If you purchase bills directly from the Treasury, a payment for the difference between the price of the new bills and the face value of your matured bills will be transferred electronically to your designated account.

Certificates of deposit. Certificates of deposit (CDs) are another form of short-term investment which offers a high return with safety and negotiability.

Certificates of deposit represent money lent by investors to a bank for a specified short period of time, generally 30, 60, or 90 days, although certificates of deposit for six months to several years are also available.

Purchasing CDs. Certificates of deposit are generally purchased through your bank or broker. The rate of interest that banks will pay depends on supply and demand in the money market. The interest rate may vary with the size of your investment. For deposits of \$100,000 or more, you may be able to get a "heavy duty" CD at a higher rate than offered on smaller deposits.

Before investing, check with the bank for minimum investment requirements, charges, and restrictions on withdrawals, including penalties for withdrawals before maturity.

Also see ¶30.15 for more on CDs.

If you have an account with a broker, you may prefer to invest in CDs through your broker. The CDs bought through a broker are federally insured up to \$100,000. Brokers offer CDs from various banks throughout the U.S. and can provide at times a higher current rate offered by a bank in an area that is not directly accessible to you.

Repurchase agreements (repos). This investment offered by banks and thrifts allows you to earn high interest rates by sharing in a portion of the bank's portfolio of government securities. The bank is required to repurchase your investment from you at your request. The minimum investment is \$1,000; maturities vary, on average, three months. Repos are not FDIC or FSLIC insured, and there is no interest penalty for early repurchase, as long as you hold them for a minimum of a week or more. There may be a small service charge for early repurchase.

Commercial paper. Periodically during the year, many corporations requiring large sums of money to finance short-term customer

receivables offer short-term promissory notes at high rates of interest. These notes are generally referred to as commercial paper. Although much of this paper is sold in units of \$100,000 or more, commercial paper in denominations of \$25,000 and even less is sometimes available.

Finance companies, automobile manufacturers, and large retail stores are types of businesses which typically issue commercial paper for periods ranging from one week to 270 days.

Investments in commercial paper may not be as liquid as other short-term paper and are subject to greater risks.

Tax-exempt notes are discussed at ¶30.18.

¶30.15 Investing in Savings Institutions

Bank money-market accounts compete with money-market mutual funds. Bank money-market funds generally guarantee for one-week or one-month periods interest rates tied to the Treasury bill rate or the average money-market rate. Bank funds also offer this added attraction: They are federally insured. Bank money-market accounts require certain average monthly balances and if the account falls below the minimum, the interest rate is reduced.

Investments in money-market funds allow you to take advantage of rising interest rates, but if market rates decline, so will your return. Investments in CDs allow you to lock into the highest available interest rate for a fixed period of time if you are concerned with a decline of rates during that period.

Withdrawals generally may be made from money-market accounts without penalty, subject to minimum account requirements. Premature withdrawals from CDs are penalized.

CD investments in savings institutions allow you to lock into high interest rates only for the short term, generally up to five years. If you are concerned that rates will substantially decline in the future, you may want to invest in a currently available investment that fixes a high rate over longer periods, such as bonds with long-term maturities. Bond investments are discussed in ¶30.16.

As indicated in ¶30.14, stockbrokers may offer to their customers issues of CDs from various banks and may allow you to invest at a slightly higher rate than that offered by a local bank.



Deferring Interest Income

Defer interest income by buying a six-month tax-deferred certificate after June 30. Interest is taxable in the next year when the certificate matures if the terms of the certificate specifically defer the interest to maturity. If your bank offers you the choice of when to receive the interest, deferral is not allowed. You may also defer interest by buying Treasury bills which come due next year.

Savings certificates versus Treasury bills. Treasury bills require a minimum \$10,000 investment, while certificates keyed to the Treasury bill rate usually require much lower minimums. Treasury

bill investments over the minimum must be made in multiples of \$1,000; for certificates, additional investments may be made in smaller increments. There is no fee charged for the purchase of certificates, while a fee may be charged to purchase Treasury bills unless purchased directly from the Treasury or a Federal Reserve Bank. Where you do not have the minimum to invest, some institutions may lend the difference at a lower interest rate, typically 1% to 2% over the rate earned on the certificate. Treasury bills have a tax advantage over certificates: interest on savings certificates is subject to state and local taxes; interest on Treasury bills is exempt from state and local taxes. Furthermore, there are penalties for redeeming certificates before maturity. *See* ¶4.16 for taxation of interest and for forfeiture of interest on premature withdrawals.

Investment options vary from bank to bank. Not all banks offer the maximum rates or compound interest in the same manner. Whether interest is compounded daily or annually will affect your rate of return. Each bank also has its own policy on procedures concerning maturity of certificates. Some banks automatically renew the CD for another term at the current rate unless notified to the contrary; some banks will not renew a matured CD without express authority from you. If you fail to act, you may find your funds switched to a day-of-deposit account on maturity. Banking institutions can also change their rules after you have opened an account.

¶30.16 Investing in Corporate Bonds

When you buy a corporate bond, you are lending money to the issuer of the bonds. You become a creditor of the issuing company. The corporation pledges to pay you interest on specified dates, generally twice a year, and to repay the principal on the date of maturity stated on the bond.

For investment purposes, a bond may be described according to the length of the period of maturity. Short-term bonds usually mature within one to five years, medium-term bonds in five to 20 years, and long-term bonds in 20 or more years.

Where the interest is paid out on a regular schedule, the bond is called a “current income” bond. An accrual or discount bond is a bond on which interest is accumulated and paid as part of the specified maturity value (the bond having been issued at a price lower than the specified maturity value).

Figuring the yield of a bond. The investment value of bonds is generally expressed in rates of yield. There are four types of yield: the nominal or coupon yield; the actual yield; the current market yield; and the net yield to maturity.

The nominal or coupon yield is the fixed or contractual rate of interest stated on the bond. A bond paying 6% has a 6% nominal yield.

The actual yield is the rate of return based on the price at which the bond was purchased. If bought below par, the actual yield will exceed the nominal or coupon yield. If bought at a premium (above par), the actual yield will be less than the coupon or nominal yield. For example, if you paid \$850 for a \$1,000 bond paying 5% interest, the actual yield is 5.88% ($\$50 \div \850).

The current market yield is the rate of return on the bond if bought at the prevailing market price. It is figured in the same manner as actual yield.

Net yield to maturity represents the rate of return on the bond if it is held to maturity, plus appreciation allocated to a discount purchase or less reductions for any premium paid on a bond selling above par. If you buy a bond below par at a market discount, your annual return is proportionately increased by a part of the discount allocated to the number of years before maturity. If the discount was \$50 on a bond with a five-year maturity, then your annual income return on the bond is increased by \$10 ($\$50 \div 5$). On the other hand, if you bought at a premium, the extra cost is a reduction against your income because you paid more than can be recovered at maturity. This cost is allocated over the remaining life of the bond. Thus, if you bought a five-year bond at \$50 over par, your average annual return is reduced by \$10 ($\$50 \div 5$).

Call privileges may reduce the investment value of the bond. A call privilege gives the issuer a chance to redeem the obligation before maturity if interest rates have declined below the rate fixed by the obligation. A call privilege is a disadvantage to an investor; a favorable investment may be lost at a time the investor may not be able to replace it with another. To take some of the “sting” out of a call provision, the issuer may provide for the payment of a “premium” on the exercise of the call and a minimum period during which the bonds will not be called. The call premium is usually expressed as a percentage of the maturity value, for example, 105%. The amount of the premium varies with the length of the period in which the bond may be called. As the maturity date approaches, the call premium will decrease. Some bonds now carry a guarantee that they will not be called for a specified number of years, such as five or 10 years.

A call privilege generally will not be exercised if the going interest rate remains about the same as, or is higher than, the interest rate of the bond. If interest rates decline below the interest rate of the bond, the bond will probably be called because the issuer can obtain the borrowed money at lower cost elsewhere.

Interest on bearer bonds issued with coupons attached is paid when a bondholder clips the coupon and deposits it for payment. A registered bond carries the name of the owner, who receives his or her interest by mail from the issuing corporation.

Whether a bond is registered or in bearer form has no effect on its investment quality or yield. A coupon-type or bearer bond may be preferred by institutional investors because it can be transferred by hand without registration. However, this advantage must be weighed against the risks of loss through fire, theft, or casualty.

Issuing and trading bonds. New bond issues are generally placed through investment bankers who usually assist in the preparation of the issue. Often an issue may be sold directly by the issuing organization to an institutional investor. Many newly issued bonds are purchased directly from issuers or from their investment bankers by institutional investors before the bonds are offered to individual investors. Issuers prefer this type of placement as it involves less expense than a public offering. Normally, only the new issues (or part of new issues) which cannot be marketed this way are offered to private investors.

Bonds are also traded on the open market where individuals, as well as institutional buyers, may buy or sell them at competitive, market determined prices, through dealers or brokers.

Bond prices fluctuate in response to changes in interest rates and business conditions. In setting the daily price of a bond, the market weighs the current status, performance, and future prospects of the issuing corporation, as well as the interest rate and maturity period of the bond.

Quotations are based on 100 as equal to par, even though the basic unit for an actual bond may be in denominations of \$1,000. A quote of 90½ simply means a bond with a face value of \$1,000 will cost \$905 at market.

Calls under sinking fund redemption. A bond may be called in at par under the terms of a sinking fund arrangement. Not all bonds are called and those that are selected are picked by lot. Redemptions for sinking fund purposes account for only a small percentage of a single bond issue. But some issues may retain the right to use a blanket sinking fund under which they may redeem bonds paying interest at their highest rate.

Put privileges. A put privilege is the flipside of a call privilege. It permits the buyer to sell the bonds at par to the issuer after a stated number of years. This feature is valuable to investors for long-term bonds. If interest rates rise, investors are not locked into low yields.

Current interest rates affect the selling price of bonds so that you may gain or lose on your investment:

1. *If current interest rates increase over the interest rate of your bond, the market value of your bond will decline.* The decline in value has nothing to do with the credit rating of the issue. It simply means that other investors will buy only at terms that will give them the current higher return. If you bought a \$1,000 bond paying a rate of 6% at par, and a few months later interest rates go to 8%, another investor will not pay \$1,000 for the bond for a 6% return. To match the 8% return on a dollar, the market value of the bond will drop to a level which will return 8% on the money invested, based on its actual 6% return and the period remaining before maturity. Thus, during periods of rising interest rates, the price of bonds issued at lower rates in prior years declines. This can lead to substantial losses, as bond investors learned in 1993–94. Top-quality bonds are not immune from price declines; the highest credit rating will not protect the market value of a low-interest-paying bond. When this happens there also may be bond bargains, as prices on outstanding bonds decrease.
2. *If interest rates decline below the interest rate of your bond, the value of your bond will increase;* but at the same time, the company, if it has an exercisable call option, may redeem the bond to rid itself of the high interest cost and attempt to raise funds at current lower rates. Thus, an early redemption of the bond could upset your long-range investment plans in that particular issue.

With these points in mind, you can understand why investors have shied away from long-term bonds as interest rates rise. Investors prefer shorter-term bonds, which pay lower interest but have more stable value.

Corporate zero coupon bond. A zero coupon bond is a deep discount obligation issued at considerably less than face value and redeemed at face at a set date. No annual interest is paid. A zero coupon bond allows an investor to lock in a return. He or she knows how much will be received at maturity and so avoids the problem of turning over investments at fluctuating short-term rates. However, zero coupon bonds may be subject to “call” provisions, as previously discussed; an early call would upset your projected return. Brokers have lists of zero coupon bonds; the prices vary with the credit rating of the companies, current market rates, maturity dates, and whether the bond is callable.

Floating rate or variable interest bonds. For investors unwilling to gamble on the future of interest rates, some bonds have been offered with floating interest rates. The rate is updated periodically, but there may be a floor and ceiling limiting the changes. The market price of the bond should remain near par since its interest rate moves with the market. Although this feature is a form of insurance for the investor, it may not be worth its added cost.



Reporting Zero Coupon Bond Discount

Zero coupon bond discount is reported annually as interest over the life of the bond, even though interest is not received. This tax cost tends to make zero coupon bonds unattractive to investors, unless the bonds can be bought for IRA and other retirement plans which defer tax on income until distributions are made.

Zero coupon bonds also may be a means of financing a child's education. A parent buys the bond for the child. The child must report the income, and if the income is not subject to the parent's marginal tax bracket under the “kiddie tax” (Chapter 24), the income subject to tax may be minimal.

The value of zero coupon bonds fluctuates sharply with interest rate changes. This fact should be considered before investing in long-term zero coupon bonds. If you sell zero coupon bonds before the maturity term, at a time when interest rates rise, you may lose part of your investment.

¶30.17

Treasury Bonds, Notes, and U.S. Agency Obligations

The federal government offers the following obligations for investment opportunities. They are guaranteed by the federal government and are exempt from state and local taxes.

Treasury bonds and notes. Treasury bonds have maturity dates in excess of 10 years. The minimum denomination is \$1,000. Interest is paid semiannually at a rate which varies with each issue. These bonds may be purchased through a commercial bank or directly from the Federal Reserve Bank.

Treasury notes are similar to Treasury bonds but have shorter maturity dates of from two to 10 years. Minimum investments range from \$1,000 to \$5,000, depending on the issue. Interest is paid semi-annually and interest varies with each issue. Notes are purchased from commercial banks or directly from the Federal Reserve Bank.

Treasury notes and bonds are issued in book-entry form only; you do not receive a certificate. Under a direct deposit system, semi-annual interest and principal at maturity is electronically deposited in a bank account which you designate.

Zero coupon Treasury bonds. Certain major brokerage houses have created zero coupon Treasury bonds by stripping the coupons from Treasury bonds and selling the bonds at deep discounts. They have been promoted under such names as TIGRS, LIONS, COUGARS, and CATS as investments suitable for IRAs, retirement plan trusts, and custodian accounts for minors. The U.S. Treasury itself offers its own version of the zero coupon bond under the name STRIPS. The government does not offer STRIPS directly to individual investors, but sells them to banks and brokers who then sell them to the public. Because STRIPS have the direct backing of the U.S. government, they are considered to be the safest zeros and generally yield up to one-tenth of one percent less than brokerage firm or bank created zero coupon bonds, such as TIGRS or CATS. With all zero coupon Treasury obligations, an investor can select a particular maturity date suited to his or her needs, such as the year the investor will start taking IRA distributions or the year a child will start college. For tax reporting rules, *see* ¶30.16 on corporate zero coupon bonds.

Other U.S. obligations, such as savings bonds, are discussed at ¶30.21 and Treasury bills at ¶30.14.

Certain federal agencies, like the Tennessee Valley Authority, offer their own securities. The types of securities offered vary. Such securities must be purchased through brokers or commercial banks.

Federally chartered companies, such as the Government National Mortgage Association ("Ginnie Mae") and the Federal National Mortgage Association ("Fannie Mae"), authorize certain firms and institutions to issue securities based on insured mortgages. While interest on these securities is generally not exempt from state and local taxes, they offer the investor a higher yield than Treasury securities. Some of these obligations carry a U.S. government full faith and credit guarantee; some have only an implied guarantee; and some no backing from the federal government, but risk is generally considered to be negligible.

Ginnie Maes are offered in minimum denominations of \$25,000. Monthly payments to security holders include not only interest, but also a return of principal. Rather than buying Ginnie Maes in the open market, you may consider investing in a mutual fund or trust which has a portfolio of such securities. Minimum investment units typically begin at \$1,000.



Treasury Inflation-Indexed Bonds

The U.S. Treasury, when this book went to press, was planning to offer a new type of bond which would be indexed to inflation. The bond would pay currently taxable interest at a fixed rate. However, if inflation affected its value, the basis of the bond would be increased to reflect the inflation factor. Bondholders would be taxed on this adjustment. For an update on inflation-indexed bonds, see the Supplement.

¶30.18 Investing in Tax-Exempts

Interest on state and local obligations is not subject to federal income tax. It is also exempt from the tax of the state in which the obligations are issued. In comparing the interest return of a tax-exempt with that of a taxable bond, you figure the taxable return that is equivalent to the tax-free yield of the tax-exempt. This amount depends on your tax bracket. For example, a municipal bond of \$5,000 yielding 7% is the equivalent of a taxable yield of 9.7% subject to the tax rate of 28%.

You can compare the value of tax-exempt interest to taxable interest for your tax bracket by using this formula:

$$\frac{\text{Tax-exempt return}}{1 \text{ minus your tax bracket}}$$

The denominator of the above fraction is:

- 0.85 if your tax bracket is 15%
- 0.72 if your tax bracket is 28%
- 0.69 if your tax bracket is 31%
- 0.64 if your tax bracket is 36%
- 0.604 if your tax bracket is 39.6%

EXAMPLE

You are deciding between a tax-exempt bond and a taxable bond. You want to find which will give you more income after taxes. You have a choice between a tax-exempt bond paying 6% and a taxable bond paying 8%. Your tax bracket is 28%.

You find that the tax-exempt bond is a better buy in your tax bracket as it is the equivalent of a taxable bond paying 8.3%.

$$T = \frac{0.06}{0.72 (1 - 0.28)}$$

$$T = .083 \text{ or } 8.3\%$$

The following table shows the amount a taxable bond would have to earn to equal the tax-exempt bond, according to the investor's income tax bracket.

If top income tax rate is—	*A tax-exempt yield of—					
	3%	4%	5%	6%	7%	8%
	is the equivalent of these taxable yields:					
28%	4.2	5.5	6.9	8.3	9.7	11.1
31%	4.3	5.8	7.2	8.7	10.1	11.6
36%	4.7	6.3	7.8	9.4	10.9	12.5
39.6%	5.0	6.6	8.3	9.9	11.6	13.2

*Exemption from the tax of the state issuing the bond will increase the yield.

To lock in high rates, you may have to invest in a long-term bond. However, consider these drawbacks: You may not want to tie up your capital long term. There is the possibility that a future increase in interest rates may reduce the value of your investment if you should need the principal before maturity.

Ratings of tax-exempt bonds. As in the case of commercial bonds, tax-exempt issues are rated by services such as Standard & Poor's and Moody's. In rating a bond, the services will consider the size of the issuer, the amount of its outstanding debt, its past record in paying off prior debts, whether it has competent officials and a balanced budget, its tax assessment and collection record, and whether the community is dominated by a single industry which might be subject to economic change. Generally, an issuer with a good credit rating will offer lower interest rates than one plagued with revenue deficits or similar problems. A basic test is the sufficiency of tax yields or revenues even in times of economic stress.

General obligation bonds will normally be rated higher than revenue bonds because they have the support of the taxing power of the community. Revenue bonds (backed by the revenue of the issuer) may receive high ratings once a capacity to produce earnings is shown.

Purchase and trading of tax-exempts. Tax-exempt municipals are traded over the counter and are generally handled through a firm specializing in this field or having a department for municipals. Prices quoted represent a percentage of par. For example, a par value \$5,000 bond quoted at 90 is selling for \$4,500 (90% of \$5,000); a par value \$1,000 bond quoted at 90 is selling for \$900 (90% of \$1,000). It may not pay to buy tax-exempts unless you intend to hold them to maturity because the additional cost of selling a small order might be as much as a year's interest.

The bid and asked prices of tax-exempt bonds are generally not quoted in the daily newspapers, although some brokerage houses which specialize in them do print such prices. As in the general bond market, an offer of unusually high interest compared with the average bond rates may be an indication that the bonds are riskier than others.

The market for tax-exempts is not as large as the market for stock. This poses a risk if you ever need ready cash and are forced to sell a tax-exempt bond at a discount. If you are concerned with liquidity, restrict your investments to major general obligation bonds of state governments and revenue bonds of major authorities.

Mutual funds. Instead of purchasing tax-exempts directly, you may consider investing in municipal bond funds. The funds invest in various municipal bonds and, thus, offer the safety of diversity. The value of fund shares will fluctuate with the bond markets. Also, an investment in the fund may be as small as \$1,000 compared with the typical \$5,000 municipal bond. Check on fees and other restrictions in municipal bond funds.

You may also invest in tax-free money-market mutual funds. These provide ready liquidity and protect the value of your principal by maintaining a \$1 value per share. The tax-exempt yield is generally lower than from a municipal bond fund.

Tax-exempt notes. Although generally bought by banks and large corporations, short-term tax-exempt notes may be available to individuals. The majority of the notes are offered in face amounts of \$25,000 and up, but sometimes in denominations of \$5,000 and \$10,000. They are issued by states and municipalities to tide them over until expected revenues are received or until longer-term money can be raised through an issue of long term bonds. Where rising interest rates have made the cost of long term issues high, a government authority may postpone a long-term offering and try to fill the gap with short-term notes. The interest rates on tax-exempt notes may be higher than on tax-exempt bonds if the authority is willing to pay the extra interest for the short term in the expectation that a future long-term offering may be placed at lower rates.

Interest on these short-term notes is exempt from federal tax. Many of the notes are from housing authorities and issued to pay construction costs on projects for which bonds will eventually be issued. Housing notes are guaranteed by the FHA and, because of their safety, yields are lower than more speculative paper.

Tax law restrictions. Most municipal bonds that are issued before July 1, 1983, except for housing issues, are in the form of bearer bonds; the owners are not identified, and interest coupons are cashed as they come due. However, state and municipal bonds issued after June 30, 1983, with a maturity of more than one year, as well as obligations of the federal government and its agencies, are in registered form. Principal and interest are transferable only through an entry on the books of the issuer.

In buying state or local bonds, check the prospectus for the issue date and tax status of the bond. The tax law treats bonds issued after August 7, 1986, as follows:

1. "Public-purpose" bonds. These include bonds issued directly by state or local governments or their agencies to meet essential government functions, such as highway construction and school financing. These bonds are generally tax exempt.
2. "Qualified private activity" bonds. These include bonds issued to finance housing and student loans. There are limits on the amount of qualifying private activity bonds an authority may issue. Interest on qualifying bonds issued after August 7, 1986 (or after August 31, 1986, for certain bonds), is tax free for regular income tax purposes, but is a preference item to be added to taxable income if you are subject to alternative minimum tax.

Because of the AMT, a nongovernment-purpose bond may pay slightly more interest than public-purpose bonds. These may be a good investment if you are not subject to AMT tax or if your AMT liability is not substantial. Your broker can help you identify such bonds.

3. “Taxable” municipals. These are bonds issued for nonqualifying private purposes. They are subject to federal income tax, but may be exempt from state and local taxes in the states in which they are issued. Generally, bonds issued after August 15, 1986, are subject to this rule.

Tax deferral for gains rolled over into SSBIC stock. To encourage investments in specialized small business investment companies and partnerships (SSBICs), a tax deferral is allowed for gains realized on the sale of publicly traded securities to the extent the sale proceeds are invested in an SSBIC. The SSBIC investment must be made within 60 days of the sale.

Details of the deferral provision are discussed at ¶5.5. If gain is deferred, the deferred amount reduces your basis of the acquired SSBIC stock or partnership interest.

¶30.19 Investing in Unit Investment Trusts

A unit investment trust is a closed-end unmanaged portfolio of bonds marketed by investment houses. Yield is fixed for the life of the trust with interest payable semiannually or more frequently. As bonds in the portfolio mature, a unit holder receives a repayment of principal. Unit trusts provide investors with the possibility of locking into high yields for the long term. However, a trust has this disadvantage: If principal is needed before the end of the trust term, an investor may sacrifice substantial amounts of principal if interest rates rise or if the general investment market is shying away from long-term investments; even where the trust may offer a current return equal to market value, its price may be depressed because there may be few investors willing to take the risk of tying up their funds in long-term investments. Despite these drawbacks, the performance of unit trusts has been rated higher than that of similar mutual funds.

Unit trusts hold varying types of debt instruments. Tax-exempt municipal bond trusts, made up of tax-exempt obligations, are generally favored by investors in the top tax brackets. Taxable unit trusts hold investments such as corporate bonds, bank certificates of deposit, and Treasury obligations. Usually, units are offered in denominations of \$1,000. An investor pays a front-end sales charge, but no management fee as there is no need for management once a unit trust is closed.

Maturities of the various trusts range as follows: The short-term, tax-exempt average is three years; intermediate, six to 12 years; and long-term, 18 to 30 years. An average for corporate intermediate is six years, with 25 years for long-term.

¶30.20 Investing in Small Business Stock

To encourage investments in certain small businesses, a 50% exclusion is available for capital gains realized on stocks issued after August 10, 1993, and held for more than five years in relatively small corporations meeting certain capitalization tests.

¶30.21 Savings Bond Plans

Savings bond purchases give you an opportunity to defer tax; *see* ¶4.28. EE bonds can be purchased for one-half the face value (ranging from \$50 to a maximum of \$10,000).

EE bonds issued on and after May 1, 1995, earn interest at rates tied to Treasury Securities from the date of purchase through original maturity in 17 years. For the first five years they earn a rate (set each May 1 and November 1) that is equal to 85% of the average six-month Treasury bill rate for the preceding three-month period. From five years through 17 years, the rate is 85% of the average yield on five-year Treasury securities during the preceding six-month period. There is no guaranteed minimum rate, but if the Treasury-based rates are not sufficient for the bond to reach face value in 17 years, the Treasury will make a one-time adjustment to bring it to face value at that time.

EE bonds issued before May 1, 1995, earn a guaranteed minimum rate, and if held at least five years, a rate tied to Treasury securities if that is greater than the minimum rate.

Deferring tax on savings bond interest. Unless you report the interest annually, Series E and EE bond interest is deferred (¶4.29) until the year you redeem the bond or it reaches final maturity. When you redeem the bond, the accumulated interest is taxable on your federal return but *not* taxable on your state and local income tax return. If in the year of redemption you use the proceeds to pay for higher education or vocational school costs, the accumulated interest may be tax free for federal tax purposes; *see* ¶33.3.

Interest accrual dates for Series E and Series EE savings bonds. Interest on Series E bonds accrues twice a year. The months of accrual depend on the issue date of the bond, as shown in the chart on page 442. When you cash a bond, you receive the value of the bond as of the last date that interest was added. If you cash a bond in between accrual months, you will not receive interest for the partial period. For example, if interest accrues in February and August, and you cash a bond in during July, you would earn interest only through February.

A similar twice-a-year accrual rule applies to Series EE bonds, except for those issued from March 1993 through April 1995 which accrue interest monthly. See the chart on the next page.

Final maturity for savings bonds. Do not neglect the final maturity date for older bonds. After the final maturity date, no further interest will accrue. For example, Series E savings bonds issued in 1956 mature in 1996 and will not earn further interest. E bonds issued in 1966 also reached final maturity in 1996. E bonds issued in 1957 and in 1967 will reach final maturity in 1997. If you have bonds that are maturing, and have deferred the reporting of interest, you may continue the deferral by exchanging the matured bonds for HH bonds. HH bonds are available in multiples of \$500, and pay taxable interest semiannually. If the exchange is made, and you choose to continue the deferral, the interest on the E bonds will not be taxed until the HH bonds are cashed or reach maturity. HH bonds mature in 20 years. The exchange may be made within one year after the E bond reaches final maturity.

Bond	Issue Date	Final Maturity
Series E	May 1941–November 1965	40 years after issue
	December 1965–June 1980	30 years after issue
Series EE	January 1980 or later	30 years after issue
Savings notes (Freedom Shares)	May 1967–October 1970	30 years after issue
H bonds	February 1957–December 1979	30 years after issue



Timing Bond Redemptions

In the year you cash in a savings bond you could lose interest by cashing it in too soon. Interest accrues only twice a year on E bonds and on EE bonds issued prior to March 1, 1993 or after April 1995. Bonds issued at different times have different accrual dates. If you cash your bonds before the accrual date that applies to your bond, you will lose interest. For a list of interest accrual dates, see the chart on the next page.

For EE bonds issued after February 1993 and before May 1995, interest is credited on the first day of each month.

Accrual dates for Series HH bonds. Taxable interest on HH bonds obtained in exchange for savings bonds or savings notes accrues semiannually at a fixed rate. For HH bonds issued or entering an extended maturity period after February 1993, the rate is 4%. Interest on HH bonds issued before March 1, 1993, will retain their guaranteed minimum rate until they reach original maturity. Interest accrues on HH bonds until final maturity 20 years from the date of issue.

Accrual dates for Series H bonds. These bonds were available before 1980. They were bought at face value and pay semiannual interest that is taxable when received. If you own Series H bonds purchased through the exchange of Series E bonds, see ¶4.28 for reporting interest. Final maturity for H bonds is 30 years from original issue.

ACCRUAL DATES FOR SERIES E AND EE BONDS

<i>Issue Date—</i>	<i>Accrual Months—</i>	<i>Example—</i>
May 1952– January 1957 E Bonds	Second month after issue month <i>and</i> eighth month after issue month. Bonds reach final maturity 40 years after issue.*	If your bond was issued in January 1957, interest accrued every March (two months after the January issue month) and every September (eight months after the January issue month). Final maturity is in January 1997, 40 years after issue.
February 1957– May 1959 E Bonds	Fifth month after issue month <i>and</i> eleventh month after issue month. Bonds reach final maturity 40 years after issue.*	If you have a bond issued in June 1958, interest accrues every November (five months after the June issue month) and every May (11 months after the June issue month).
June 1959– November 1965 E Bonds	Third month after issue month <i>and</i> ninth month after issue month. Bonds reach final maturity 40 years after issue.*	If you have a bond issued in September 1964, interest accrues every December (three months after the September issue month) and every June (nine months after the September issue month).
December 1965– May 1969 E Bonds	Sixth month after issue month <i>and</i> original issue month. Bonds reach final maturity 30 years after issue.*	If you have a bond issued in October 1968, interest accrues every April (six months after the October issue month) and every October (month of original issue).
June 1969– November 1973 E Bonds	Fourth month after issue month <i>and</i> tenth month after issue month. Bonds reach final maturity 30 years after issue.*	If you have a bond issued in July 1971, interest accrues every November (four months after the July issue month) and every May (10 months after the July issue month).
December 1973– June 1980 E Bonds	Sixth month after issue month <i>and</i> original issue month. Bonds reach final maturity 30 years after issue.*	If you have a bond issued in May 1979, interest accrues every November (six months after the May issue month) and every May (month of original issue).
January 1980– February 1993 EE Bonds	Sixth month after issue month <i>and</i> original issue month. Bonds reach final maturity 30 years after issue.*	If you have a bond issued in June 1990, interest accrues every December (six months after the June issue month) and every June (month of original issue).
March 1993– April 1995 EE Bonds	Interest is credited on the first day of every month. Bonds reach final maturity 30 years after issue.*	
After April 1995 EE Bonds	Sixth month after issue month <i>and</i> original issue month. Bonds reach final maturity 30 years after issue.*	If you have a bond issued in August 1995, interest accrues every February (six months after the August issue month) and every August (month of original issue).

* Last interest accrual on final maturity date.